change in costs. After that change in the PCI, the LECs would have precisely the same incentives to control OPEB costs as any other expenses. In particular, Z-factor treatment of SFAS 106 accounting changes does not imply that expense recovery for OPEBs is assured. On the contrary, it places OPEB expenses and wage expenses on precisely the same footing, so that the LEC will have the same incentives to control OPEB costs as it does to control wages.

III. REPLY TO MCI

MCI raises two issues that we already addressed in our initial report: (i) how adoption of SFAS 106 affects economic costs and prices for unregulated firms and (ii) the possible double counting of medical inflation.

A. SFAS 106, Economic Costs and Prices[17]

MCI's criticism of our report on this issue is summarized in the following quote.

> "The NERA study is encumbered by the assumptions of classical economics -- perfect competition in the market for goods, services, and all inputs to the production process, perfect information, and no transaction costs. It performs a tautology: prices are assumed to reflect economic costs, therefore any change that is purely accounting will by definition have absolutely no impact. This model is clearly too restrictive and assumes away the complexities of the real world. Such a structure is totally inappropriate for the analysis of the issue at hand, that is, the impact of an increase in labor costs driven by SFAS-106 on the GNP-PI." (p. 22)

Apart from listing assumptions we never made (perfect competition, perfect information, no transaction costs), the gist of MCI's accusation seems to be that we acted as economists. We plead guilty to this count. The real issue is not whether economics simplifies the complexities of the real world, but whether an economic perspective provides insight into the problem and whether

[17]MCI also criticizes our study for not performing a statistical analysis of interrelationships among sectors of the economy. As we responded to Ad Hoc/ETI, since we developed an upper bound for the effect of SFAS 106 on GNP-PI, we assumed conservatively high levels of interactions between sectors. Accordingly, a behavioral econometric model and accompanying formal statistical analysis is not required.

the outcomes predicted by economic theory are reasonable for the purpose at hand. We believe that our application of economic theory provides a reasonable upper bound to the effect of SFAS 106 accounting changes on GNP-PI.

MCI has no apparent disagreement with our fundamental premise -- the change to accrual accounting has no impact on the underlying economic costs. [18](p. 10) Having reached this agreement, economic theory becomes very useful in indicating how prices are expected to adjust when costs have not changed. Whether the situation is perfect competition, imperfect competition, or unregulated monopoly, economic theory predicts no price changes when economic costs haven't changed. This expectation is corroborated by the findings we cited on how stock prices responded to the SFAS 87 pension accounting changes and by financial analysts' expectations regarding the adoption of SFAS 106 -- namely no price response can be inferred.[19]

B. Double Counting Medical Inflation

On pages 29 to 31, MCI argues that because medical inflation appears in both the calculation of accrual accounting expenses under SFAS 106 and in the GNP-PI, double counting has necessarily occurred. We discussed this issue in detail in our report (pp. 23 - 25) and concluded that this apparent problem does not exist. Since MCI apparently has ignored or failed to understand our analysis, we will repeat it here.

The LEC proposal for a one time Z-factor adjustment brings LEC costs closer to economic costs. In essence, the effect of the proposal is the same as if initial rates under price

---

[18]Note that MCI contradicts its correct conclusion regarding economic costs with its statement that SFAS 106 increases labor costs, which we cited above.

[19]Curiously, MCI (p. 16) claims that we concluded that there was no literature supporting our theory. In fact, our report on the page cited by MCI discusses studies that demonstrate the lack of impact of changing accounting standards on share prices. Further, the Middelstaedt/Warshawsky study cited in the Drazen affidavit demonstrated that share prices decline as OPEB liability grows (which is consistent with economic theory), not that the expected change in accounting standards has affected stock prices, as MCI seems to believe.

caps had been established consistent with accrual accounting for OPEBs. Had this occurred, OPEB expenses would not have received special treatment under price caps, even though expected medical inflation was a determinant of these expenses. Under price caps, even though particular input prices may have inflation rates that differ from the inflation in GNP-PI, individual treatment is inappropriate.

Of course, medical inflation does affect the anticipated inflation rate of the economic costs of OPEBs, and thus it also affects the magnitude of the one-time Z-factor adjustment.[20] The one-time Z-factor adjustment (which depends on anticipated medical inflation) combined with future price changes determined by GNP-PI does not, however, double count medical inflation. The one-time Z-factor adjustment effectively resets the regulated firm's PCI so that its prices reflect accrual accounting for OPEBs. Once that one-time adjustment is made, the firm must change its PCI by the full amount of the change in GNP-PI - X (not by the change in GNP-PI - X less medical inflation) in order that the change in its PCI just match the change in its costs, given that it reaches its productivity objective X. After the one-time Z-factor adjustment, changes in medical prices should be treated the same way that changes in prices of other inputs of the firm (*e.g.*, wages) are treated.

A simple example illustrates this point. Suppose scientists discover that central offices emit harmful electromagnetic waves that can be contained by wrapping the buildings in plastic. The plastic wrap lasts exactly one year (so that the cost is an expense rather than an investment). If regulators order plastic wrap as a safety measure, the LECs' costs have increased on a going-forward basis as a result of the order. Now, if this safety measure is permanent, an appropriate treatment under price caps is a one-time Z-factor adjustment that effectively incorporates the cost of the plastic wrap into the PCI, followed by business-as-usual application of the price cap formula

[20]Earlier, we explained how AT&T's adjustment to the calculation of accrual accounting expenses that netted out medical inflation was wrong.

in subsequent years. The resulting situation would be no different than if the cost of the protective wrap had been part of the LECs' regulated prices before price caps. Again, even though the inflation rate for plastic wrap may differ from the inflation rate measured by GNP-PI, no special treatment of a particular input is warranted under price caps.

<u>CERTIFICATE OF SERVICE</u>

I, C. A. Helms, hereby certify that copies of the foregoing "REBUTTAL OF PACIFIC BELL AND NEVADA BELL TO OPPOSITIONS TO THEIR DIRECT CASE", re CC Docket No. 92-101, were served by hand or by first-class United States mail, postage prepaid, upon the parties on the attached Service List on this 31st day of July, 1992.

By: ______________________
C. A. Helms

PACIFIC BELL
140 New Montgomery Street
San Francisco, California 94105

0524B

Service List

Donna R. Searcy, Secretary *
Federal Communications Commission
1919 M Street, N.W., Ste 222
Washington, D.C. 20554

Gregory Vogt *
Chief, Tariff Division
Federal Communications Commission
1919 M St., N.W., Rm. 518
Washington, D.C. 20554

Policy & Program Planning Division *
Common Carrier Bureau
Federal Communications Commission
1919 M St., N.W., Rm. 544
Washington, D.C. 20554

Downtown Copy Center *
1990 M St., N.W., Rm. 640
Washington, D.C. 20036

James S. Blaszak
Attorney for AD HOC
1301 K St., N.W., Ste 900-East Tower
Washington, D.C. 20005

Francine J. Berry
Attorney for AT&T
295 North Maple Ave., Rm. 3244J1
Basking Ridge, NJ 07920

Michael F. Hydock
Senior Staff Member-MCI
1801 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Brian R. Moir
Attorney for ICA
1255 23rd St., N.W., Ste. 800
Washington, D.C. 20037-1170

*Served by Hand

James R. Young
Bell Atlantic Telephone Companies
1710 H Street, N.W.
Washington, D.C. 20006

William B. Barfield
BellSouth Telephone Companies
1155 Peachtree Street, N.E.
Suite 1800
Atlanta, GA 30367-6000

Mary McDermott
NYNEX Telephone Companies
120 Bloomingdale Road
White Plains, NY 10605

Josephine S. Trubek
Rochester Telephone Corporation
180 South Clinton Avenue
Rochester, NY 14646

Linda D. Hershman
Vice President - External Affairs
Southern New England Telephone Company
227 Church Street
New Haven, CT 06510-1806

William C. Sullivan
Southwestern Bell Telephone Company
1010 Pine Street, Room 2305
St. Louis, MO 63101

Jay C. Keithley
United Telephone System
1850 M Street N.W.
Suite 1100
Washington, D.C. 20036

Dana Rasmussen
US West Communications, Inc.
1020 19th St., N.W., Suite 700
Washington, D.C. 20036

Floyd S. Keene
Attorney for Ameritech
2000 West Ameritech Center Dr., Rm. 4H64
Hoffman Estates, IL 60196-1025

Richard McKenna
Attorney for GTE
P. O. Box 152092
Irving, TX 75015-2092

Gail L. Polivy
Attorney for GTE
1850 M Street, N.W., Ste. 1200
Washington, D.C. 20036